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FDI, catch-up growth stages and stage-focused strategies

by
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This is a reply to Francisco Sercovich's commentary[1] on my *Perspective* on FDI-led industrial takeoff in which I described foreign direct investment (FDI) as an ignition for catch-up industrialization.[2] He emphasized "the rich and nuanced variety of strategic options"[3] (e.g., S&T policies, engineering education, *chaebol*-type enterprises for technology absorption, R&D capabilities), which are, however, relevant only to *higher*-stages of catch-up, but *not* to the *kick-off* stage with which my previous *Perspective* was concerned. Economic development derives from structural changes at different stages of growth, requiring stages-focused strategies.

The FDI-led takeoff applies to the *beginning* stage of catch-up in which labor-abundant emerging economies have an endowed comparative advantage in low-end manufacturing. Higher stages are obviously built increasingly on knowledge and demand more sophisticated approaches. As I stated, "China now has to reformulate and refine its growth strategy as it climbs higher on the ladder...."[4] Each stage calls for different preparatory measures, institutions and strategies.[5]

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[1] Francisco Sercovich, "Knowledge, FDI and catching-up strategies," *Columbia FDI Perspectives*, No. 53 (December 19, 2011).

[2] Terutomo Ozawa, "The role of multinationals in sparking industrialization: From 'infant industry protection' to 'FDI-led industrial take-off,'" *Columbia FDI Perspectives*, No. 39 (June 6, 2011).

[3] Sercovich, op. cit., para. 1.

[4] Ozawa, op. cit., para. 9.

[5] For a policy framework, see a "leading-sector growth" model in Terutomo Ozawa, "The (Japan-born) 'flying-geese' theory of economic development revisited -- and reformulated from a structuralist perspective," *Global Policy*, vol. 2 (October 2011), pp. 272-285.

Also, the notion of infant industry protection (IIP) has come to be stretched to cover practically any type of development measure. The FDI-led model was conceptualized as opposed to the *conventional* IIP theory epitomized in the Alexander Hamilton-Friedrich List approach that stresses import substitution to build a *locally owned* industry under protection-cum-promotion -- *not* under general development policies, *allowing* foreign advances into domestic industries.

In this respect, postwar Japan effectively pursued the Hamilton-List IIP strategy in modernizing its capital-intensive industries (e.g., steel, machinery, automobiles) by borrowing and improving on Western technologies. However, war-devastated Japan re-started *first* with then-comparatively advantaged, labor-intensive light industries and quickly redeveloped exports (e.g., toys, textiles). Japan's light industries did not need -- and in fact, *avoided* -- investments by foreign multinational enterprises (MNEs).

In contrast, Singapore, Taiwan Province of China and the Republic of Korea deliberately had to set up export-processing zones to attract labor-seeking FDI in the 1960s-70s, since they lacked the experience of producing manufactured exports. And they quickly succeeded in attracting labor-intensive manufacturing, the *first* step to industrial modernization. China, too, emulated its neighbors' successes by opening up for trade and FDI in 1978. China's special economic zones and low-wage labor enticed foreign MNEs to build China's low-cost, export-driven manufacturing, swiftly alleviating poverty.

The FDI-led kick-off has thus become a *new* jump-starter of industrialization and a more *expedient* alternative to the inward-looking IIP strategy. Such a start of industrial modernization *does not* require the sophisticated measures cited by Sercovich. In fact, this is the reason why the World Bank is urging China to relocate low-wage factories to Africa in order to help spark industrialization, although Africa (other than South Africa) *still* lacks nuanced strategic capacities (like S&T capabilities, *chaebol*-type technological competence and R&D competition with foreign MNEs).

As to *chaebol*-type conglomerates as a strategic option, they were actually not needed when the Republic of Korea was exporting labor-intensive goods (e.g., wigs, toys, footwear), initially from its Masan export-processing zone opened in 1970. Only in the *subsequent*, *higher* stages of catch-up (i.e., heavy and chemical industrialization and the development of assembly-based industries) *chaebols* became a powerful instrument -- just as Japan's postwar *keiretsu* firms did -- for building scale-driven, capital-intensive industries (e.g., shipbuilding, machinery, microchips, automobiles). True, the government sagaciously began to make efforts to establish these higher-stage industries under IIP-cum-subsidies, starting as early as the late 1960s (e.g., the Electronics Industry Promotion Law of 1969 initially to encourage *assembly* operations of monochrome TVs, i.e., from the *low*-end of a knowledge-based industry). All these industries, however, grew internationally competitive *only in later and more recent decades*. Interestingly, *chaebols* may now be even considered outdated in an era of entrepreneurship and start-ups spawned by information technology.

Thus, the criticality of a stages perspective cannot be overstressed. For instance, to ask Africa's unindustrialized countries to organize *chaebol*-type enterprises and invest in S&T capabilities is premature *at the moment*; instead, Africa should *first* apply its *limited* development resources (including policy capacity) to attracting FDI in labor-intensive manufacturing to ignite an FDI-led takeoff. This must be what the World Bank has in mind. True, there may be other options, such as fostering small and medium-size domestic manufacturers in hopes of an autonomous export-led kick-off. Some even propose a skipping-a-step strategy to enter a high-end industry. But this approach, even if workable, risks unbalanced development, leaving the region's comparative advantage in labor-intensive industries untapped -- hence, the impoverished masses still under and un-employed. Once it gets kick-started, however, more intricate higher-stage strategies are needed to sustain catch-up. In sum, it makes sense *first* to exploit *endowed* advantages and then try to "create" new ones.

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